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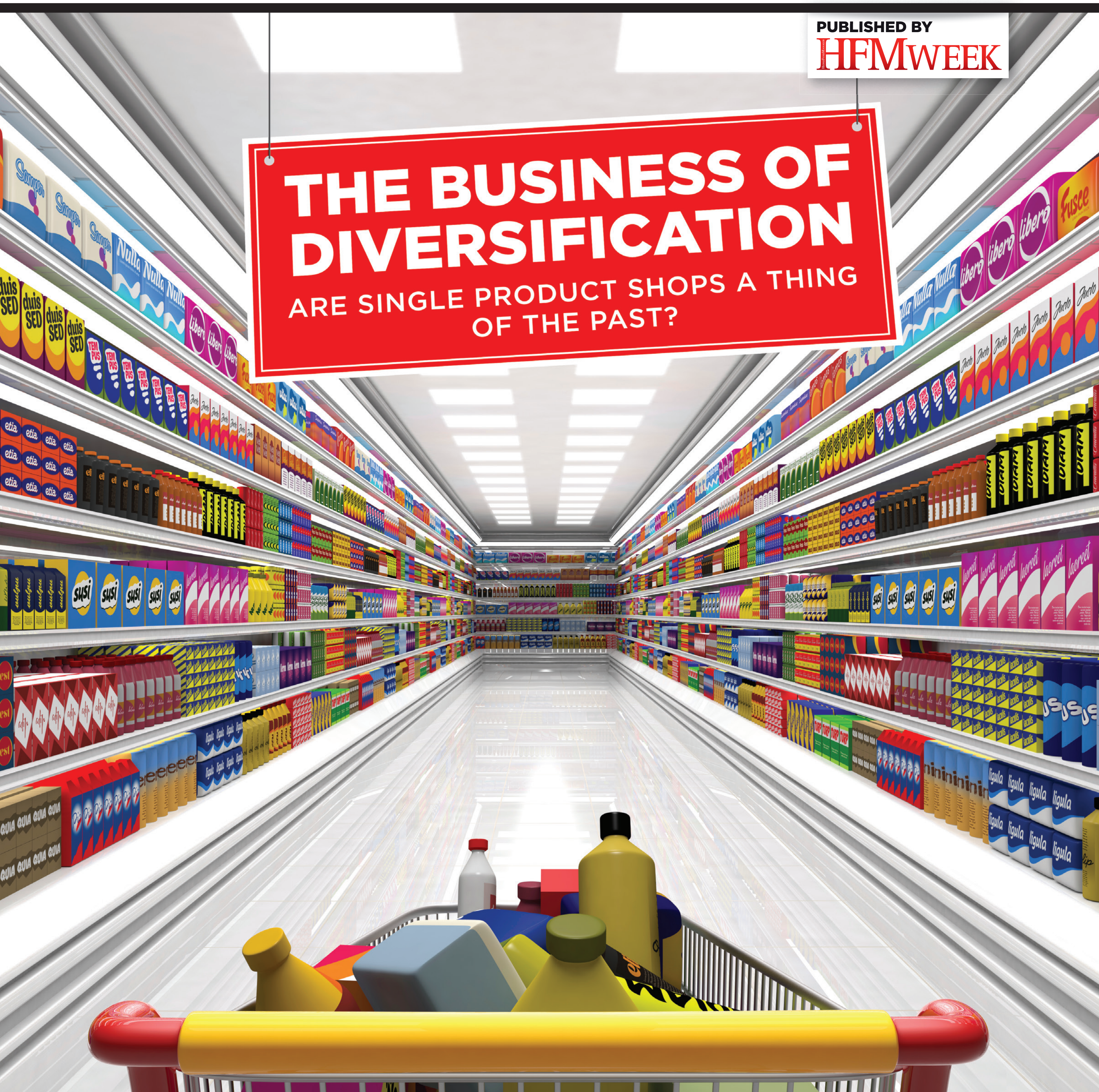


THE BUSINESS OF DIVERSIFICATION
ARE SINGLE PRODUCT SHOPS A THING OF THE PAST?

Spotlight: Warrington Asset Management

The Dallas-based options manager 'spins out' from Morgan Stanley to reach a broader client base

BY MATT SMITH

Scott C Kimple says he always knew he wanted to be in money management. However, if things had turned out differently he could have been running the family manufacturing business.

Today the investment firm he founded, Warrington Asset Management, is embarking on a turning point in its own history.

The options trading shop has been effectively operating for the past two decades as an internal CTA of one of the dominant US wire houses.

While Warrington has held a CTA registration in its own right since 2000, its S&P 500 index focused investment strategy had until this year been exclusively offered as a product by Morgan Stanley, and before that, Citigroup.

Now the Dallas-based manager has spun-out on its own with a freedom to reach a broader range of investors.

At the start of the year, Warrington ended its internal affiliation as a registered representative of Morgan Stanley. And on 31 March, the bank's Ceres Managed Futures subsidiary will withdraw as general partner of the Managed Futures Premier Warrington fund, leaving Warrington to assume responsibility for its operation and roughly £130m of assets.

A new onshore fund, the Warrington Strategic Fund, is set to open for investors outside of the wire house platform.

It will trade the same options program as the Premier Warrington fund, which has delivered an 11% compounded annualised return since its 1997 inception.

"The relationship we had was unusual," explains Kimple, who has been contemplating the move for a number of years. All the other managers on the platform outside of us had the relationship we're moving into.

"It was a good business decision for us. Prior to this we were generally limited to investors having an account with Morgan Stanley. For them, having an internal CTA that they were the general partner of in this new regulatory environment, it was better for us to be off their books.

"And it is better for us now as we can attract capital from any source out there."

Warrington was previously able to leverage Morgan Stanley's back office and compliance resources so it didn't need to build a large staff. It had a team of five, including Kimple and long-time business partner Mark Adams, the firm's assistant portfolio manager and resident quant.

But after the pair decided to take their operation independent they quickly moved to fill in the gaps. They brought on board a COO, Greg Fomin, in October.

He was previously a senior managing director at Blue River Partners, an alternatives consulting firm, and head of hedge fund development at EAM Partners. Before that, he was general counsel and chief compliance officer at Hunt Financial Ventures, a hedge fund seeder and FoHFs.

Kenneth Webster, a former president and COO of John W Henry & Co has signed on as an adviser to Warrington.

And Warrington has plans to assemble an advisory board of "industry luminaries," says Kimple.

Meanwhile, Apex Fund Services have been hired as administrator, and Warrington's FCM relationships are being broadened to Wells Fargo and FC Stone to replace Morgan Stanley.

For Kimple, the transition marks a departure from a 24-year relationship with Morgan Stanley and its predecessor firms, dating back to Shearson, Lehman, Hutton, where he started his professional money management career.

Starting early

Kimple got an early introduction to trading. However as a child Kimple had been groomed to take over the packaging manufacturing business that his grandfather had started, and his father ran.

The firm was traded on one of the US stock exchanges and Kimple would travel with his father on business trips to New York, where he would be taken onto the floor of the American Stock Exchange (AMEX) with the firm's specialist.

"Even though I was conditioned that I was going to run this company at some point, I gained an early interest in the stock market. The specialist was like my baby sitter when I went to New York."

Kimple recalls a fascination with stocks, and by osmosis it all started to sink in.

He started trading aged 16 with $1,000 from his father and had some early success which piqued his interest in money management.

As a freshman in college at Southern Methodist University (SMU), his father decided to sell the family company and some of the proceeds were invested with a CTA and broker for Shearson Lehman Brothers named Stan Finney, who was one of the bigger traders in S&P futures options at the time. He would become a mentor to Kimple.

Kimple remembers voraciously reading books on options and as a business administration undergraduate at SMU would trade futures and options before class with Rock Pletcher, a family attorney.

Kimple went on to study finance and derivative securities as part of an MBA, and as a graduate student started working with Finney to conduct a technical analysis study. He was hired by Finney to begin his career at Shearson, trading S&P futures options.

At the time, Finney had a unique business model. He was allowed to have his own company but was also dually registered with Shearson. He ran a fund captive inside Shearson that was offered to clients of its financial advisers.

Kimple worked for Finney from 1990 to 1993, and remained with Shearson through its merger with Primerica's Smith Barney, becoming a vice president and financial consultant.

Finney was primarily a premium seller, and Kimple initially followed a similar style.

When Kimple went out on his own, he discovered Finney's approach incurred a high level of risk and suffered some trading losses in the mid-90s.

"That's when I decided I wanted to develop a strategy that used the same general tenets of the mathematics of options pricing, but did it in a way that stripped out a lot of the volatility: The picking up nickels in front of a stream roller," says Kimple.

Spread trading offered a way to do this. Kimple sought to create a strategy that could deliver consistent non-volatile returns in any stock market environment. The spread trading program he came up with was implemented in 1997.

"I'm not averse to selling some premium but the spread strategies we employ mitigate a lot of the risk around outright premium selling and give us a strategy that has a risk return profile significantly different than your typical options trader," he says.

One of the indicators Kimple came up with was a band chart - like a Bollinger band but static around a 21-day moving average.

Warrington's band chart incorporates 90% of the historical activity of the S&P500 dating back to the 1950s. Most premium sellers try to sell outside of this range.

TEXAS ROOTS

Warrington is a Texan firm to its core. Principals Scott Kimple and Mark Adams *(pictured left)* were both born and bred in the Lone Star state.

Adams, the assistant portfolio manager, joined the firm in 2002 as an intern during graduate school at SMU, where he was taught by the same derivative securities professor as Kimple had been more than 10 years earlier.

He had canvassed SMU alumni in the investment field while looking for work experience and found Kimple.

"Sure enough, we worked really well together. His business started growing by leaps and bounds and I kind of worked myself into a job," Adams says. He joined full time in the summer of 2003.

Dallas, where Warrington is based, is home to 24 of the near 2,500 CTAs on the NFA's register. By contrast, Chicago has 183 and New York 296.

While the city has become one of the largest centres for hedge fund managers in the US, best known for its energy, long/short equity and credit funds, this is no disadvantage for Warrington.

It has a dynamic business community, and hedge fund managers who have set up there point to a collegial environment.

"It's a very active hedge fund community," says Kimple. "Very supportive."

Warrington is based in one of the towers that make up The Crescent, a flagship office complex among Dallas's hedge fund centric office buildings. These are home to the likes of HBK, Carlson. Highland, Hayman Capital, and Maverick. The city also has a more diversified local investor base than state rival Houston, from corporate and real estate to investment and energy wealth.

Kimple says something of a "frontier culture" still exists, and people tend to be more open to a more diversified set of investments.

"We trade our options to try to capture range within the band structure which is diametrically opposed to most premium sellers," Kimple notes.

One key tenet of Warrington's strategy is always to trade the front month expiration, although there are now more products to trade than the monthlies available when the firm first started out.

"We don't care if the market goes up, down or sideways, but that it oscillates within the band and allows us to trade around and capture that range.

"Ideally at expiration, one of our longs, a call or put, is significantly in the money, and our shorts are still out of the money.

"Within one to three days before expiry we cover the position and then look to roll it out to the next expiration cycle."

We trade our options to try to capture range within the band structure which is diametrically opposed to most premium sellers

Warrington set out to create a program that didn't correlate to stocks, fixed income or other alternative managers.

Kimple and Adams position their program as a portfolio diversifier - even to other managed futures programs, which are predominantly systematic trend-followers. It has a 0.09 correlation to the Barclay CTA Index.

"We're discretionary fundamentalists," says Kimple. "We're looking to be a small piece of an investor's overall portfolio allocation with the idea that we give them something that's fairly unique in terms of its risk return profile".

The nature of its program means Warrington is limited to the types of trade it can put on.

But Kimple says the firm's edge is in the way it applies them, along with market experience.

"When we develop trades, we use a process that is somewhat unique in that we are highly quantitatively driven," he says.

"We have a number of proprietary models that we developed but also we follow a number of more traditional models and over-bought/over-sold indicators."

To approach a position Warrington first develops a market opinion, which is quantitatively driven.

It then applies a fundamental overlay which incorporates non-quantifiable factors that could impact the stock markets over the short-term horizon of its trades.

"Right now our quant models are somewhat bullish, but we've got the situation in Greece which has been a chronic problem for a number of years," Kimple says.

"We've got a new QE program in Europe and we've got the Fed actually winding up their QE and talking about the potential for raising interest rates. We look to try to handicap these non-quantifiable factors and generally impute them for risk management."

To enter trades Warrington analyses different time sequences of options, all within the front month expiration cycles.

"We will look for the optimal options strategy to capitalise on our market opinion within the time horizon, and that's where the discretion really factors in," says Kimple.

"We have only a finite number of types of trade we can utilise, but we apply those trades given the market opinion or market environment we find ourselves in."

Warrington had stellar annual returns in the late 1990s, and strong double-digit annual returns for most of the 2000s until 2008, when it saw losses in the final four months of the year, ending the year down -17%. It bounced back with a 18% gain in 2009, before a loss in 2010 of -7%. Both 2011 and 2012 both saw 12%-plus annual returns. But returns since then have been more muted.

"In the QE environment of recent years we've not been able to apply call spreads as much," explains Kimple, noting they haven't made as much sense from a price perspective.

But he adds: "We believe going forward in the absence of US QE, and with the untried nature of European QE, we expect more volatility, and as volatility is a key input into our trading, we welcome a little more of it."

Kimple says Warrington's program will perform best in "historically normalised markets".

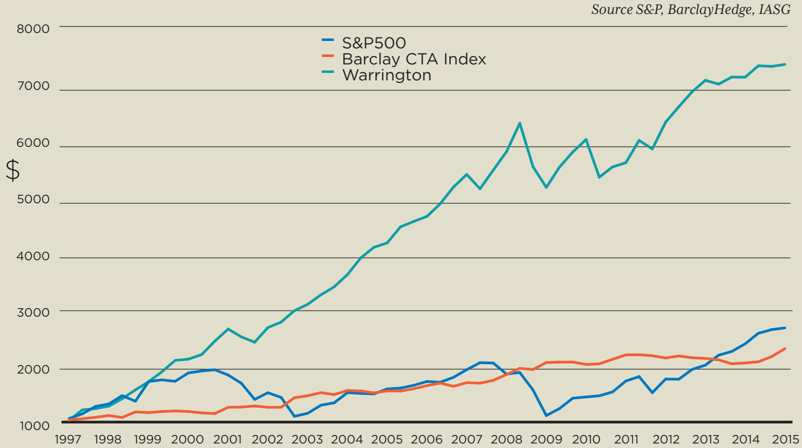
When the S&P starts moving into historically anomalous markets, Warrington approaches the market fully hedged or will go to cash until it moves back into a high confidence range of the historical band chart.

"To use the baseball analogy we go for singles and doubles. We don't like to take too much risk as we don't want to strike out," he says.

"We are highly focused on risk management and if we don't think we have an edge it's very easy for us to stand aside, or only place trades that we think have a good solid risk return profile."

GROWTH OF $1000 WITH WARRINGTON AM

Source S&P, BarclayHedge, IASG



The Crescent development in uptown Dallas has become a hub for hedge funds near the city's financial community

Kimple says the firm has always been "high-touch manager" to both client and adviser, offering direct access to its portfolio managers.

"Anytime a client had a question or any issue, say if the market has been challenging during the day, we guaranteed them that if they called us, we would always return calls by sunset on that same day," Kimple says.

It's an approach that Warrington will continue as it prepares to attract other types of investors.

"I enjoy having the interaction with clients and financial advisers. We want a client to be able get "under the hood" with us and be as granular as they want to be," he says, adding it is important they understand the diversification value that a small allocation to managed futures can bring to a portfolio.

Kimple is optimistic that investors are now looking beyond systematic trend-following for non-correlated additions to a portfolio.

"Managed futures prior to '08 were not terribly well utilised by wire houses and financial advisers in general," he says. "2008 really convinced them that their clients do need real non-correlation, real diversification. In '08 you saw that from the systematic trend-following sub-set of managed futures, and I think that really piqued a lot of client and adviser curiosities about the space."

Kimple says while the lack of performance of trend-following after the financial crisis left some financial advisers and clients disappointed and frustrated, the depth of understanding of managed futures has been increased and many now see the need for diversification within the space.

Warrington trades just 100 round turns/$m/ month. Its return profile shows shallow drawdowns compared to many options trading peers.

For example in October 2014, when the S&P500 dropped 200 points followed by a hairpin turn and 270 point rally many premium sellers had a very difficult time, sustaining double digit losses. Warrington lost 0.6% that month.

"We've had a few hiccups along the way, but our approach has allowed us to have a good 18-year track record, and side-step some of the higher volatility events that have caused a lot of pain in that side of the arena."

Warrington aims to protect capital, and it never takes a risk in a client's portfolio of longer than four or five weeks before options expiration.

While on Morgan Stanley's platform, Warrington's program was sold by an army of up 17,000 financial advisers, yet its core assets came through under 100 adviser relationships; from those who understood managed futures, had the required sales licence for such a strategy, and had sophisticated investor clients.

Warrington was at one point managing money across more than 1,000 Morgan Stanley affiliated managed accounts, although they were mostly rolled into a fund structure in 2006. AuM peaked at $356m in June 2008.

To use the baseball analogy we go for singles and doubles. We don't like to take too much risk as we don't want to strike out

Warrington's new fund will open on 1 April with around $10-20m, based on current commitments.

The firm is also exploring the potential for an offshore fund as well as a European Ucits or AIF fund as it plans to grow its asset base beyond HNWIs and smaller institutions.

"We know we're an options strategy so it does require a bit more explanation and hand holding," Kimple noted. "But we are talking to institutions, funds of funds, family offices. Looking at other platforms. Right now we're looking for where there is the most demand."

And Kimple notes wryly: "An addition of a discretionary component like Warrington's strategy to systematic trend-following is additive and necessary to give real exposure to managed futures in general." CTA